

Case No. A09-1822
**STATE OF MINNESOTA
IN COURT OF APPEALS**

**T.E.S. Construction, Inc.
Plaintiff/Respondent,**

vs.

**STEPHEN J. CHICILLO
Defendant/Appellant,**

APPELLANT'S REPLY BRIEF

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TABLE OF CONTENTS

	Page
Table of Authorities	3
Argument	4
Overview	4
Respondent's Use of Term 'Payments'	4
Application, Interpretation & Construction of §514.02	5
§514.02 Does Not Apply to Payments By Owners of Real Estate	7
§514.02 Does Not Apply to Use of Mortgage Proceeds	11
Respondent's Claims of Fraud	13
Conclusion	17

TABLE OF AUTHORITIES

	Page
Statutes	
<u>Minnesota Statutes</u> , §514.01	4-5, 7, 9-10, 13
<u>Minnesota Statutes</u> , §514.02	passim
<u>Minnesota Statutes</u> , §645.16	5-6
Cases	
<u>State v. Boyce</u> , WL 3153017, p. 3 (Minn. App. 2007 – Unpublished)	11-13
<u>MacArthur Company v. Crea</u> , 31 B.R. 239, 245 (Bky. Dist. Minn. 1983)	7-9, 13
<u>Nelson v. Nelson</u> , 415 N.W.2d 694 (Minn. App. 1987)	8
<u>Pella Prods., Inc. v. Arvig Tel. Co.</u> , 488 N.W.2d 316 (Minn. App. 1992)	6
<u>Siemens Bldg. Technologies, Inc. v. Peak Mechanical, Inc.</u> , 684 N.W.2d 914 (Minn.App.,2004)	7, 10, 13
<u>State of Minnesota v. Bren</u> , 704 N.W.2d 170 (Minn. App. 2005)	7, 9-11, 13
<u>State of Minnesota v. Reys</u> , 223 N.W.2d 780 (Minn. 1974)	7, 9-11, 13
<u>United States Fidelity and Guarantee Company v. Excel Bank of Minnesota</u> (Unpublished, No. A04-726 Dec. 21, 2004)	7-8, 13

ARGUMENT

The parties are in agreement that there are few, if any, material facts in dispute and that the core issues in this case are questions of statutory interpretation which are subject to de novo review by this court.

Overview.

Respondent's argument is premised upon a misunderstanding of *Minnesota Statutes*, §514.02. It continues to confuse payments by a mortgage company on the order of a lender with payments by a homeowner for an improvement to real estate. However, the statute is reasonably clear on this point in two respects.

Respondent's Use of the Term "Payments".

First, the statute is designed to cover, in its own words, "Proceeds of payments received by a person contributing to an improvement to real estate within the meaning of section 514.01". *Minnesota Statutes*, §514.01 in turn refers to payments by an owner under contract for the improvement of the owner's property. The statute refers to work done "under contract with the owner of such real estate or at the instance of any agent, trustee, contractor, or subcontractor of the owner." The payments that are the subject of this litigation on the other hand were payments by a mortgage lender. They are proceeds of a loan, *not* proceeds of a payment made on a contract the mortgagee had on the property. The funds paid were money paid by agreement of Defendant and lender. The

money was paid because Appellant applied for a loan, not because SP Framing or anyone else framed a house.

Respondent's analysis is wholly semantic. It insists on using the words 'pay' and 'payment' in the broadest sense that could apply to any monetary transaction. But §514.01 and §514.02 clearly limit the use of the statutes to misapplication of payments made by an owner for an improvement made by a contractor. The substance of the mortgage transaction is not covered by this language. The money paid by the lender was paid as a loan to the borrower, not to purchase framing services. The obligation to repay the loan remains regardless of how the money was used. In other words, the payments in question were payments made at the order of Chicilo Homes. In other words, the Respondent is suing Defendant for borrowing money for a project he was unable to complete when the construction industry collapsed. The 'payments' referred to by Respondent and the trial court are in fact payments of the money of Chicilo Homes borrowed from a mortgage lender.

The trial court's decision is unprecedented. There is no reported case applying §514.02 *against* a homeowner and there is no case based on a misapplication of borrowed funds from a lender.

Application, Interpretation and Construction of Minnesota Statutes, §514.02.

Minnesota Statutes, §645.16 guides the application, construction and interpretation of laws. It provides that

“The object of all interpretation and construction of laws is to ascertain and effectuate the intention of the legislature. Every law shall be construed, if possible, to give effect to all its provisions.

“When the words of a law in their application to an existing situation are clear and free from all ambiguity, the letter of the law shall not be disregarded under the pretext of pursuing the spirit.

“When the words of a law are not explicit, the intention of the legislature may be ascertained by considering, among other matters:

- (1) the occasion and necessity for the law;
- (2) the circumstances under which it was enacted;
- (3) the mischief to be remedied;
- (4) the object to be attained;
- (5) the former law, if any, including other laws upon the same or similar subjects;
- (6) the consequences of a particular interpretation;
- (7) the contemporaneous legislative history; and
- (8) legislative and administrative interpretations of the statute.”

Further, as argued in Appellant’s Brief, mechanic’s liens are strictly construed so as not to give the statute “an application and meaning not intended by the legislature.”

Pella Prods, Inc. v. Arvig Tel. Co., 488 N.W.2d 316, 318 (Minn. App. 1992); See Appellant’s Brief, p. 11.

Respondent’s analysis is flawed because it uses the terms ‘payment’ and ‘pay’ in their broadest sense without regard for the context of the words in the statutes at issue. This usage is contrary to statute in two senses. First, the statute does not apply to application of payments by an owner of real estate; and second, the payment made by the mortgage lender was paid as part of a loan transaction and was not made for payment of an improvement.

§514.02 Does Not Apply to Payments by the Owner of Real Estate.

The history of the application of §514.02 shows that it was designed to protect homeowners against claims of unpaid subcontractors, not to assure that money borrowed for a project is used to pay contractors. This is the point of the *MacArthur*, *Reps*, *Bren*, *Siemens* and *United States Fidelity Company* cases. An unbiased analysis of the occasion and necessity of the law, the mischief to be remedied and the object to be obtained all strongly argue that §514.02 was designed to protect homeowners against the claims of subcontractors. It was not designed to coerce a homeowner to use borrowed funds for the benefit of contractors rather than any other purpose decided by the owner.

§514.02, subd. 1(a) limits application of §514.02 to "Proceeds of payments received by a person contributing to the improvement of real estate within the meaning of section 514.01." §514.01 does not apply to mortgage proceeds borrowed by a mortgage lender to improve the owner's property. This would mean the owner had created a lien not by incurring an obligation for the an improvement but rather whenever he expended money on his own property. This section refers to payments under a contract with the owner or the owner's agent, contractor or sub for the improvement of real estate. Its caption refers specifically to "Mechanics, laborers and material suppliers." The 'payment' in question in this case is not a payment under a contract for the improvement of real estate. The only contract involved is *not* a contract with a laborer or materials supplier for the improvement of real estate, but a promissory note signed by Chicilo

Homes.

Further, this statute cannot be applied to create liability for a payment made at the instance of the owner. Such a theory would result in the absurdity of an owner creating a lien against his own property. This result was expressly ruled out in the Nelson case which approvingly quoted an Iowa case saying

“[A]n essential element in establishing a lien is showing a debt or an obligation of the landowner. This element cannot be satisfied when a property owner claims a lien on his own real estate because an owner cannot owe himself a debt.” *Nelson v. Nelson*, 415 N.W.2d 694 (Minn. App. 1987) quoting *Boese*, 373 N.W.2d at 121.

Respondent has missed this point entirely. Appellant has cited a series of cases showing that §514.02 was designed to protect the owner of real estate from their contractors who expose them to liability by not paying subcontractors. For instance, Appellant cited the case of *U.S. Fidelity and Guarantee Co. v. Excel Bank of Minnesota* (Minn. App. 2004 – Unpublished No. A04-726 12/21/2004) not to question the use of a bank’s right of set off or whether funds might be subject to a statutory trust as discussed by Respondent. (*Respondent’s Brief*, p. 15) The case is of interest because of its description of §514.02:

“The purpose of this provision is to protect landowners from unscrupulous contractors, reducing the risk that landowners will face a mechanic’s lien when subcontractors are unpaid. Hearing of H.F. No. 2563 Before the House Comm. On Civil Law (Feb. 2, 2000).”

Distinguishing *MacArthur Company v. Crea*, 31 B.R. 239 (Bky. D. Minn. 1983)

because in the instant case the subcontractor was in direct contact with the owner/contractor does not undermine the importance to this case. See Respondent's Brief, p. 14. What is important is MacArthur's discussion of the purpose of §514.02,

“[§514.02] was actually designed to protect the consumers of labor and materials rather than the suppliers. Minn. Stat. §514.01 gives a supplier who furnishes materials a lien upon the improvements made with them and upon the land on which they are situated. Where a contractor fails to pay a supplier the consumer may be compelled to pay for the improvements twice if the supplier forecloses his lien. Minn. Stat. §514.02 is designed to deter subcontractors from forcing this unjust result on consumers.” Id. at p. 245.

Respondent pretends that it “is unclear how the Reps and Bren cases help the Appellant's argument. The case before the Court is a civil action and not a criminal matter.” Respondent's Brief, pp. 14-15. Respondent's analysis is defective in two respects.

First, the cited criminal cases under §514.02 directly apply to civil cases under this section as well. Section 1 of §514.02 sets out the elements of a criminal violation. Section 1a governs civil actions. There can be no civil action unless there is a “theft” under subd. 1. Subdivision 1 describes a criminal action for non payment for an improvement. It directly refers to “acts constituting theft” in its caption and makes a person who misapplies proceeds “guilty of theft of the proceeds of the payment and is punishable under section 609.52.” Civil actions are authorized under subd. 1a. However, there is no civil action under subd. 1a in the absence of a violation of the criminal portion

of the statute (subd. 1). Subd. 1a begins by saying “A person injured by violation of subdivision 1 may bring a civil action and recover damages...” It then specifies who such actions may be brought against, saying “A civil action under this subdivision may be brought: (1) against the person who committed *the theft* under subdivision 1; ...”

[emphasis added]

Second, both Reps and Bren clearly describe the relationship between §514.02 and §514.01 and the relationship of the parties described by these sections. Reps said that

“With regard to the required relationship between the parties, Minn.St. 514.02 expressly incorporates the provisions of § 514.01 in its definition of the basic, underlying event as ‘any improvement to real estate within the meaning of section 514.01,’ and the required relationships are clearly identifiable when the two sections are read together. Section 514.02, subd. 1, punishes the failure to use proceeds of any payment made *by the owner* for the payment of labor, skill, material, and machinery ‘contributed to such improvement.’ State of Minnesota v. Reps, 223 N.W.2d 780,787 (Minn. 1974). [emphasis added]

Bren also specifies the type of conduct prohibited under §514.02,

“The statute criminalizes a contractor’s misapplication of funds paid by a homeowner for an improvement to real estate, not the failure to pay a debt owed to a subcontractor.” State of Minnesota v. Bren, 704 N.W.2d 170, 177 (Minn. App. 2005).

Similarly, Siemens Bldg. Tech., Inc. V. Peak Mechanical, 648 N.W.2d 914, 918 (Minn. App. 2004) describes §514.02 as a statute which “deals with the unscrupulous or failing contractor who collects from an owner, but fails to pay subcontractors, ...”.

The cases quoted above all support the proposition that §514.02 was designed to

protect the homeowner, not to force contractors who borrow money for a project to pay over all borrowed funds to the subcontractors first on pain of criminal prosecution and civil liability.

§514.02 Does Not Cover Mortgage Proceeds Received by Appellant.

The language of §514.02 also limits its applicability to payments made for the improvement of real estate, not to mortgage proceeds borrowed to improve property. Part (b) of subd. 1 sets out a violation

"if a person fails to use the proceeds of a payment made to that person for the improvement, for the payment for labor, skill, material and machinery contributed to the improvement, knowing that the cost of the labor performed, or skill, material of machinery furnished remains unpaid..."

The statute goes on to create a trust on payments made for an improvement. Contractors are required to hold money paid by owners for improvements in trust to make sure that their subcontractors are paid. The key element for this case is that the payment was not made for an improvement but was made to Appellant because he took out a mortgage and signed a promissory note.

Respondent implores the Court to use "its' own common sense" in interpreting §514.02. It alleges *State v. Boyce* supports its view that any type of payment relating to the real estate is covered by §514.02. See *Respondent's Brief*, p. 17. This is a criminal case and Respondent has earlier argued that other cases, *Bren* and *Reps*, are not relevant because they involve the criminal section of §514.02. *Respondent's Brief*, pp. 14-15. The

language quoted speaks only about the meaning of one part of §514.02 (b). The language omitted from Respondent's quote is "that is emphasized above". The language being interpreted is one part of one *part* of §514.02, namely

"(b) If a person fails to use the proceeds of a payment made to that person for the improvement, for the payment for labor, skill, material, and machinery contributed to the improvement, knowing that the cost of the labor performed, or skill, material, or machinery furnished remains unpaid," *State v. Boyce*, WL 3153017, p. 3 (Minn. App. 2007 – Unpublished)

In context, *Boyce* applies this language to a "payment made" to a remodeler "for an improvement" not for 'money borrowed for an improvement.' The payment in *Boyce* was made for an improvement by a homeowner. The only payment made in the instant case was the payment of loan proceeds at the order of borrower to an entity Respondent argues did nothing to improve any real estate.

This case deals with a criminal prosecution for violation of §518.02 by taking money from homeowners for materials and work in remodeling their home. Funds were paid for the remodeling/improvement and subcontractors were not paid. Because a supplier of materials was not paid, a mechanic's lien was placed on the home. This is a classic use of §514.02. The payments were not simply money borrowed by an owner but actual payments received by a contractor from a homeowner. The evil the legislature meant to protect homeowners from was present. A mechanics lien was filed on the property when a materialman was not paid by the defendant remodeler. The purpose of §514.02, to protect owners against claims for improvements they have already paid a

contractor for, was clearly served in Boyce. Boyce supports Appellant's discussion of the U.S. Fidelity, MacArthur, Reps, Bren and Siemens cases, supra.

In the instant case mortgaged funds were not paid to a contractor to discharge an obligation for an improvement. Instead, a payment was made under a note creating an obligation to the owner. There is no support in case law for the use of §514.02 to create a trust on funds borrowed for an improvement.

Claims of Fraud by Respondent.

Respondent's own version of the facts argues that payments to SP Framing, Inc. are not covered by §518.02. It argues that SP Framing was a "shell company" and a "bogus framing company". Respondent's Brief, p. 9. If SP Framing in fact did not contribute to the improvement of the property, then the payments to SP on the loan payments made by request of Chicilo Homes were not "Proceeds of payments received by a person contributing to an improvement of real estate within the meaning of section 514.01". Thus, no trust has been established under the express language of §514.02, subd. 1(a).

The discussion of 'fraud' by Respondent and the trial court decision are nothing more than semantic shell game and a red herring. If there were any fraud, it was not directed against Respondent and Respondent was not damaged by it. When it suits its purposes, Respondent treats Chicilo Homes, Steven Chicilo and SP Framing as one entity. But even though Respondent cannot deny that Chicilo Homes and Steven Chicilo

contributed to the subject parcels of real estate it alleges fraud, essentially by arguing that a separate entity, SP Framing, was a bogus entity that contributed nothing to the project other than lend its name.

There are several problems with Respondent's analysis of the alleged fraud. First, even if there was a fraud in directing payments to SP Framing, Respondent was not the entity damaged by such fraud. Any misrepresentation must have directed at the lender. Certainly Respondent could not have been deceived by any such fraud. Respondent alleges it did all the framing work. If submitting lien waivers from SP Framing was then somehow deceptive Respondent could not have been 'deceived' and could not have reasonably relied on any such 'deception'.

The elements of a claim for fraud were set out in Hoyt Properties, Inc., et Al. v. Production Resource Group, 736 N.W.2d 313 (Minn. 2007),

"To make out a claim for fraudulent misrepresentation, the plaintiff must establish that:
(1) there was a false representation by a party of a past or existing material fact susceptible of knowledge; (2) made with knowledge of the falsity of the representation or made as of the party's own knowledge without knowing whether it was true or false; (3) with the intention to induce another to act in reliance thereon; (4) that the representation caused the other party to act in reliance thereon; and (5) that the party suffer[ed] pecuniary damage as a result of the reliance." Specialized Tours, Inc. v. Hagen, 392 N.W.2d 520, 532 (Minn.1986).

Thus, the elements of a claim for fraud against Respondent cannot be proven. It is difficult to identify any specific fact susceptible of knowledge. There are no specific findings concerning intention to make anyone rely thereon. It could not be credibly

argued and there is no finding that Respondent relied on a false representation.

Moreover, if the use of SP Framing caused any pecuniary loss, the only party that could have been damaged was the mortgage lender, and there are no findings setting out such loss. The object of any such 'fraud' could only have been to cause the mortgaged funds to be paid to SP Framing. There is simply nothing in the record to show how these 'payments' of funds borrowed by Chicilo Homes damaged *Respondent*.

The claim of fraud is also not borne out by the history of the parties. The parties had worked together on a number of projects over the years. SP Framing was not created to facilitate a fraud, it had been in existence since 1996. Both parties profited from their relationship in past years. Money had been borrowed on other projects and Respondent had received payment for its contributions. However, for the projects that are the subject of this litigation the borrowed funds proved not to be enough to permit the completion of the projects. When Appellant could not complete the projects he lost money, lost his investment in the projects and was unable to pay Respondent.

There are two alternative explanations of these events. One alternative is that Appellant turned his back on Respondent, saw an opportunity to defraud it and manipulated mortgage lenders to aid him in somehow cheating Respondent. The scheme must have run awry because Appellant, Respondent and the lenders all ended up losing money. The other alternative is that there was an almost unprecedented meltdown in the housing market which made it impossible for Appellant to realize his plans resulting in

losses to both parties, and frankly to others as well.

The record is sparse on evidence showing fraud because this case was not plead or tried by either party on a theory of fraud. The claim plead and argued was a count relying on the statutory remedy of §514.02.

Appellant has argued that to criminalize the use of a homeowner's mortgage proceeds or purposes other than paying a contractor would extend the statute to countless situations it was never intended to cover. And it submitted that approval of the trial court's use of this section could criminalize the cases of many homeowners when a cost overrun meant that all the contractors could not be paid. See *Respondent's Brief*, p. 19. Respondent argues that the potential harm of condoning Appellant's 'behavior' outweighs any speculative harm to the home mortgage industry. Of course, the damage is not only to the home mortgage industry but to homeowners, who §514.02 was designed to protect. However, the cases cited above clearly state that the statute used by the trial court was enacted *not* to protect contractors, but homeowners.

There is also the claim of Respondent that Appellant is trying to shift the risk on construction projects to Respondent and home lenders. *Respondent's Brief*, p. 19. It alleges that if the homes sold everyone would walk away happy, but if things did not work out Appellant could still use reduce his loss by using borrowed funds. This explanation ignores two essential facts. First, credit was essential to Chicilo Homes and the Appellant. The failure to repay creditors not only could, but has, severely damaged both.

Second, Respondent has been given a substantial means to protect its interests even against potential claims of lenders or future purchasers by simply following the law set out in Chapter 514 and filing a mechanics lien. The law is not designed to protect those like Respondent who have failed to avail themselves of the statutory remedies provided for them.

CONCLUSION

The decision of the trial court is flawed. It rests on a faulty application of §514.02 and is not supported by the record. The trial court's order and judgment must be reversed.

Dated: February 1, 2010.

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